Remarks before the
Toronto Bond Traders' Association in
Toronto, Canada, on
Tuesday, February 22, 1977

A Broader Role for Monetary Targets

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I suppose that anyone from the United States who prepares to deliver a speech to a Canadian audience thinks about some of the striking similarities—and some of the striking differences—between our two countries. After reflecting on the matter for a while, I began to be increasingly certain that, in the context of my subject for this evening, the similarities are vastly more important than the differences. Recent thinking about the problems of economic stabilization, and particularly about the objectives and techniques of monetary policy, seems to me to have run along parallel paths in Canada and the United States.

As far as bond traders are concerned, I suspect it's part of the instinct of a Canadian bond man—more so, even these days, than of an American—to recognize that economic stabilization has an increasingly international dimension. In that respect, there has been a radical change in the game since the final breakdown of the Bretton Woods system nearly four years ago.

Following the lead set by Canada, the major industrial countries came to conclude that, like it or not, we would have to live within a context of flexible exchange rates. Bitter experience had demonstrated that the earlier arrangements were too rigid and brittle to contain the pressures that build up in markets as a result of the divergent economic performances of countries.

It was not the first time that a highly structured system finally fell by the wayside under the pressure of events and new needs. In the decade following World War I, restoration of the gold standard and fixed parities, designed to provide the substance and the symbol of renewed international stability, was the goal of almost every central bank and government. In domestic policy, the simple rule was that an annually balanced budget had a high order of political, as well as economic, priority. But, under the impact of the Great Depression and the international monetary crises related to it, neither fixed exchange rates nor balanced budgets survived for long.

Following that dismal experience, strong new efforts to achieve stabilization were made after World War II. Internationally, a new par value system, freed of some of the rigidities of the gold standard, was installed at Bretton Woods. Domestically, the changes were more striking, drawing heavily on the ideas of Keynes. And for roughly two decades—particularly supported by close cooperation among the industrial countries—the new arrangements were able to support unprecedented growth and prosperity in a framework of a high degree of price stability.

But the turbulence of the 1970's brought that period to a close. We have coined some cumbersome and ugly new words—"stagflation", for instance—to describe the domestic dilemmas of many countries. Externally, we have seen some exchange rate gyrations almost as large as those of the 1930's. In this perplexing situation, theorists and policymakers alike have had to grope for new approaches and standards to guide economic management.

As a result, internationally accepted doctrine has obviously and radically changed. The current approach, as reflected in the new articles of the International Monetary Fund, has two basic premises: first, that exchange rate changes should play a more continuous and active role in the process of international adjustment; second, that the basis for any stabilization of exchange rates must lie primarily in the efforts of individual countries to achieve growth without inflation at home. It is not much of an exaggeration to say these concepts stand on its head the old doctrine—the concept that fixed exchange rates, by imposing a strong external discipline on governments and central banks, would force stability at home.

One practical implication is to place an even heavier burden on domestic policies. In a world of floating exchange rates, inflationary or deflationary forces arising in one country are less readily diffused among its trading partners. Instead, in recent experience there have been occasions when the sharp depreciation of an exchange rate aggravated domestic inflation.

The irony is that, as the support which the fixed rate system provided for internal stabilization weakened, so did confidence in the capacity and will of governments to achieve stability through domestic policy. Some of the old rules just no longer seemed very relevant.

Take one example. For more than a generation every economics textbook has taught us that the concept of an annually balanced national budget is outmoded. But somehow the more sophisticated ideas of "cyclically balanced" and "full employment" budgets seem, in practice, to have opened the way to more or less perpetual—and seemingly ever larger—deficits. Take another example. Early in the postwar period the idea developed that a "trade-off" between unemployment and prices could be carefully calculated, that it could be a guide to policy. But that trade-off has turned out to be neither stable nor meaningful in a world characterized by both high unemployment and high inflation. It has turned out that the efforts at "fine tuning" monetary, fiscal, and other policies have sometimes been as confusing as helpful in a world in which the future is never known, the lags between action and response are long and uncertain, and markets adjust to current expectations as much as to current facts.

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It is in this context of doubt and disillusionment that some ideas espoused by the so-called monetarist school have attracted new attention in the United States and elsewhere. Their main point of emphasis—that money matters—is hardly new. Indeed, the thought that there is a relationship between the supply of money and the general level of prices is one of the oldest propositions in all of economics. Few economists—and almost no central bankers—have ever disputed it. Nevertheless, for a variety of reasons, beginning in the 1930's and continuing through most of the postwar period, the emphasis in policymaking was focused on the short run, where the relationship between money and prices is less clear. While the effects of the money supply on credit markets and interest rates were generally recognized, the effects on the economy were thought not to be terribly powerful in periods of depression or recession. Attention turned elsewhere—to fiscal action, to the process of wage bargaining, and to other forces as the main determinants of economic activity and prices.

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I am not about to argue that these other forces are not important, and—in some circumstances—even crucial. There is a lot of evidence that the relation between money and prices is not very close in the short run. But there is also a hard core of truth in the central theme of the monetarist school: over time, an excess supply of money contributes nothing to employment, nor to real income, nor to real wealth, but only to inflation

In its modern dress, monetarism has also helped clear up a good deal of confusion in other respects. We have become more conscious of the difference between rates of interest as observed in the marketplace and the "real" rate of interest—that is, the return after adjustment for expected changes in purchasing power. We recognize to a greater degree the importance of expectations in explaining behavior in financial markets and in economic life generally. We have learned that lenders and borrowers have come to anticipate inflation and that they are sensitive to policies they interpret as contributing to inflation. Consequently, they sometimes may react in unaccustomed ways—for instance, by selling securities out of fear of inflation when the money supply is rising exceptionally fast, instead of using the larger supplies of money to add to their holdings. As a result, a growing money supply is no longer seen to be as closely associated with sustaining real economic growth as it used to be.

In a sense, the long run of which the monetarists speak has caught up with us. The lessons have not been lost on central banks, in the United States or elsewhere. They have responded, in their policies and policy pronouncements, by putting new emphasis on the behavior of the money supply and its related monetary aggregates. In particular, it has become the practice in the United States, in Canada, and in a number of other important countries to specify quite precisely the growth ranges, or projections, or targets —the nomenclature differs—for certain monetary aggregates over a period of a year or so ahead.

In the United States and elsewhere, there was a certain initial reluctance to adopt this approach. Given that the relationship between money and other economic variables is imperfect, the reasons are understandable. Central bankers share a human desire to want to hedge against an uncertain future. They also want to retain the ability to respond flexibly as new developments emerge, to probe experimentally with new policy measures, to test market reactions, and to learn from those reactions before fully committing themselves to follow a set course. Indeed, this flexibility to act and react has long been considered a great strength of monetary policy.

After two years of experience with projecting monetary growth ranges, the Federal Reserve still takes care to note that it does not focus exclusive attention on the monetary aggregates, and that the projections are always subject to change in the light of subsequent economic and financial developments. Moreover, the Federal Reserve has pointed out time and again that it is neither possible nor desirable to attempt close control over the growth of the monetary aggregates during short periods of time, say, a few weeks or even months—a point which I am afraid has not yet been convincing to our own bond traders as they attempt to interpret, and often overinterpret, the significance of the money supply figures we release in New York late every Thursday afternoon.

All these qualificatons and reservations are important. Yet, I have become increasingly convinced that this experiment in "practical monetarism" is proving useful. Over time, I believe it can play a part in restoring a sense of greater stability and confidence in monetary policy and in our economic performance.

Within our Federal Reserve councils, the longer range money supply projections have already provided a useful discipline for our debate. Any monetary authority faces a constant flow of new information—and thus a decision about whether to react or not. Obviously, there are dangers in reacting too fast and too much. The results of any new action may not be evident for many months, when the situation may be quite different. But equally, there are dangers in reacting too slowly or not at all. The risks in either direction are reduced when each new piece of information must be taken into account in relation to an earlier judgment and a longer perspective about the appropriate growth in the money supply.

Potentially as important is the communication of our specific ranges for monetary growth clearly to others—whether to the political authorities in the Congress and the Administration, or to business, labor, and the marketplace. It is one thing to repeat again and again, as central bankers are apt to do, our dedication to

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the general proposition that, while encouraging growth, we also want to encourage a gradual return to price stability. It is quite another thing to present, defend, and *stick to* specific numbers for monetary growth consistent with that objective.

Obviously, credibility in that respect is crucial. It can only be earned over time. That process will be speeded if we continue to specify clearly our objectives and to defend our approach in public debate.

I suspect this kind of thinking has influenced other central banks that have also adopted some form of monetary "targeting" for periods of a year or so ahead. Of course, the details differ.

You are more familiar than I am with the particular policies instituted late in 1975 by the Bank of Canada. Unlike the Federal Reserve, the Bank of Canada targets only one of the monetary aggregates—the narrowly defined money stock, M_1. The targets have generally not been reviewed publicly as frequently as in the United States. The projected range for M_1 in this country is higher. But these differences must all be interpreted in the light of a different institutional, economic, and political setting. The similarities in approach are much more striking than the differences, including the fact that both central banks have emphasized that money growth will gradually have to be reduced below presently specified ranges if price stability is to be restored.

Among European countries, Germany and Switzerland now set annual targets—single points rather than ranges—for monetary aggregates. Germany uses central bank money—a variation of high powered money or the monetary base—as the primary target of its operations. Switzerland, like Canada, uses the narrowly defined money stock as the single target. But again, the similarity in concept is more striking than the variants in detail.

Other countries appear to be moving in the same direction. The British authorities have recently been drawn, little by little, into setting a monetary target, recognizing the value of clarifying the aims of monetary policy at a time of great domestic and exchange rate uncertainty.

Late last year, the authorities in France announced their target for the growth of a broadly defined money stock during 1977. On the other side of the world, Japan appears to be moving cautiously in the same direction. While the Bank of Japan currently does not make public announcements, we know that every quarter it sets targets for the broadly defined money stock.

It is of course too soon to pronounce any final judgment on the success of these experiments in "practical monetarism"; whether they will turn out to be only a passing fad or a really significant change in the way we approach and implement monetary policy. Certainly, we will need to recognize and deal with some potential pitfalls that could arise if the concept is applied too rigidly.

We must constantly be aware that, whatever the stability in the relationship between money and income or gross national product in the long run, there is considerable instability in the relationship over the shorter runs that are relevant to the policymaker. For instance, we in the United States found that the tax rebates we gave to individuals in 1975 pushed monetary growth substantially higher for a month or two because the money was at first deposited in checking accounts. The impact proved temporary. Similar behavior can be anticipated as a result of the rebates that seem almost certain to be given this year. Perhaps more significant is that, over much of the past year and longer, the relationship between money, interest rates, and nominal income has not always been in line with earlier cyclical patterns. That helps, among other things, to explain why most forecasts of rising interest rates went awry.

In circumstances like these, central bankers need to take account of other information beyond the statistics on monetary growth from week to week or month to month in shaping their policy actions. As we do, we are in the position of constantly balancing the danger of failing to react in a timely way to changes in monetary growth against the danger of reacting too fast and too aggressively. If we choose wrongly, we are forced to retrace our steps as more or better information becomes available.

Clearly, there are risks in not responding in a timely way to bulges or shortfalls in the money supply relative to specified objectives. If a new turn in the statistics turns out to be significant, delays may make it much more difficult to get back on the track of the longer term objective. Moreover, unexpected changes may be telling us something important about economic developments that we would ignore at our peril.

But the danger of overreacting to deviations in the aggregates from targets is just as real. Statistically, in our experience there is a high probability that any deviation from the established trend over a month or two—even of considerable size—will prove temporary. In the United States, at least, most week to week fluctuations can be close to meaningless. Attempts to respond immediately by tightening or easing the supply of reserves will probably only slowly effect the money supply, but in the attempt the market can be whipsawed. More confusion than light might be thrown on our intentions if our short-term gyrations in open market operations serve to confuse what our long-term strategy continues to be.

The importance of this point is reinforced at times when market conditions may deserve attention in their own right. There have been a number of occasions when markets were unusually sensitive or disturbed—so much disturbed that a potential impact on business sentiment and financial availabilities could not be ignored. At such times, even relatively small changes in the apparent posture of the Federal Reserve may trigger expectations in the market that are entirely out of proportion to any presumed gain in tracking monetary targets.

You will have to try to make sense out of all those monetary data that central banks pour out in ever greater volume, and you will have to learn how the central banks themselves are likely to respond.

More broadly, I think the intellectual emphasis on monetary aggregates has sometimes gone too far in implying that credit market conditions "don't count". In the view of some monetarists, market conditions don't count in the sense that they do not consider market conditions an independent source of disturbance in the economy, or a legitimate concern of policy. My experience has been to the contrary. There have been a number of occasions in the 1970's when the Federal Reserve had to pay the closest possible attention to particular financial problems and to the potential vulnerability of various credit markets. The recurrent concerns in my country about the capacity of thrift institutions to perform their role as intermediaries between savers and the mortgage market is one example. The potential disturbances growing out of the Penn Central Railroad and the Franklin and the Herstatt Bank affairs are another class of examples. The strain on the municipal bond markets and the concerns about the rising level of losses commercial banks were taking on loans a year or so ago are other cases in point. Those problems had to be dealt with—actually or potentially—by techniques that cannot be encompassed by any simple monetary rule.

All of this presents important questions of approach and tactics in pursuing monetary objectives. Each central bank will have to develop techniques shaped to its own institutions and needs.

But, even after taking account of other policy requirements, the record in adhering to specified monetary targets has so far been fairly good. Here in Canada, as you know, growth in the narrowly defined money supply, despite sharp monthly variations, has been generally consistent with the established target range despite the slippage down to and below the bottom of the range in recent months. Among European countries which have announced single point targets rather than ranges, no central bank has scored a bull's-eye. But the performances have been reasonably close to the mark.

In the United States, too, growth of the monetary aggregates during 1976 was broadly consistent with the Federal Reserve's long-run projections. Measured from the fourth quarter of 1975 to the fourth quarter of 1976, M_1 advanced by 5.5 percent—well within the range announced for that period. At the same time, growth rates of the broader aggregates were close to the upper ends of their respective ranges.

I recognize that the point can be made that this record has been achieved, at least in my country, in a rather favorable environment. Specifically, we were able to realize our monetary objectives within a context of economic growth, some abatement of inflationary pressures, and generally stable interest rates. In this view, the real test will come only when financial pressures, or concerns about the course of economic activity, become greater and, therefore, generate strong new demands for money creation as the solution for such problems.

I would agree that the strength of the commitment of central banks to the new approach remains to be challenged in adversity. But perhaps it would also be correct to suggest that monetary policy has to some degree facilitated achieving the improvement in economic conditions.

In the end, the new approach will have to stand or fall on the basis of how well it is rooted in reality, on the validity of the basic proposition that excessive growth in the money supply can only feed inflation, and that it will not assist us in meeting our underlying goal of sustained prosperity My own judgment is that we already have ample evidence that strong inflationary forces, and a renewal of inflationary expectations, will damage rather than help our prospects for employment and growth. What remains to be seen is whether those propositions have become so widely and clearly understood that the old temptations to turn to the printing press in the effort to reach our objectives can be resisted.

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In recent years, some of the old hallmarks of sound and responsible policies—particularly fixed exchange rates and balanced budgets—have been weakened or destroyed. They broke down at least in part because, applied too rigidly, they no longer fit the realities of the time. But I suspect that the loss of those anchors for policy—however understandable and justifiable—has something to do with the sense of uncertainty and instability that has been so prevalent in this decade.

I hope the new focus on containing monetary growth can fill some of that void. In substance, the concept is relatively straightforward and readily understood. It embodies an essential truth in a manner that can be clearly communicated. Performance can be readily monitored. In that sense, both the symbols and substance of effective monetary policy can be brought together in a comprehensible way.

If the new approach in fact proves useful in helping to achieve stability in our domestic economies, the benefits should be reflected in an increased degree of stability in our international economic relationships as well. To be sure, economic, political, and social conditions vary from country to country. Among other consequences of that fact, we can expect different rates of inflation to persist for some time. And, faced with unique circumstances, different central banks will choose different goals for monetary growth.

All of this will influence exchange rates. Indeed, changes in exchange rates should not be resisted—ultimately they cannot be resisted—when they reflect deep-seated changes in relative economic circumstances.

What we can reasonably seek is an environment in which those exchange rate changes take place relatively smoothly, without the exaggerations and sense of turbulence, uncertainty, and crisis that have been so common in recent years. It seems to me evident that that basic objective will be served as the domestic intentions of the monetary authorities become more predictable, and as confidence in the domestic monetary framework grows. As I see it, the practice of specifying monetary targets will contribute to that end. But, of course, we need to do more than simply set targets. We will need to demonstrate our ability to adhere to the targets. And we will need to act to bring monetary growth targets gradually down to noninflationary levels.

We still have a long way to go before we can claim success. Those of us responsible for monetary policy will need to develop the new techniques and to resolve many problems of tactics as well as strategy. In our own actions, we will need to justify and make credible our claims that inflation can be brought under control.

Those of you dealing in financial markets will also need to adjust and to learn. First, you will have to try to make sense out of all those monetary data that central banks pour out in ever greater volume, and you will have to learn how the central banks themselves are likely to respond. Ultimately, as you gain confidence, I hope you will also see the profit potential in taking a longer view about securities prices and exchange rates. I also hope that you will come to appreciate the risks and dangers of following the crowd in response to the latest fad or fears.

I welcome this process of adjustment and learning. I have high hopes that the new approaches toward money management I have discussed tonight can help point us toward greater stability in both our domestic economies and in the exchange rate system. With a little patience and fortitude, I believe those present hopes can be converted to firm expectations.